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REACTIONS TO THE RECENT SUBPRIME MORTGAGE COLLAPSE

Monday, March 26, 2007

State Capitol, Room 113

1:00 PM – 3:00 PM

- I. **Introduction and Welcoming Remarks** – Senator Michael Machado, Chair
- II. **Panel Discussion – Observed and Predicted Impacts of the Recent Subprime Mortgage Collapse**

Paul Leonard, Director, California Office, Center for Responsible Lending

Nancy Wallace, Professor, UC Berkeley Haas School of Business

Stuart Gabriel, Lusk Chair, Professor of Finance and Economics, USC Marshall School of Business

Doug Duncan, Senior Vice President and Chief Economist, Mortgage Bankers Association

Ed Smith, Jr., Chief Executive Officer, Plaza Financial Group, Inc.

Leigh Rutledge, Realtor, Dunnigan – Sierra Oaks and Vice Chair of the California Association of Realtors Legislative Committee

- III. **Update From State Regulators Regarding Their Role in Responding To Lender Failures**

Michael Kelley, Commissioner, Department of Financial Institutions

Preston DuFauchard, Commissioner, Department of Corporations

- IV. **Public Comment**

**REACTIONS TO THE RECENT SUBPRIME
MORTGAGE MARKET COLLAPSE**

WHAT'S NEXT FOR CALIFORNIA?

**SENATE BANKING, FINANCE & INSURANCE
COMMITTEE**

MICHAEL J. MACHADO, CHAIR

BACKGROUND PAPER

INTRODUCTION

On January 31, 2007, the Senate Banking, Finance & Insurance Committee held an informational hearing on nontraditional mortgage products. At the time of that hearing, some had begun expressing fear about future weakness in the subprime market, but many believed that the subprime sector remained strong, and that appropriate underwriting was in place to protect both lenders and borrowers.

In the eight weeks since that January hearing, the subprime mortgage market has been shaken to its core. Over twenty subprime lenders have shut their doors and ceased making new loans. The share prices of those lenders whose stock is still trading have fallen precipitously. The index used to gauge investor confidence in subprime mortgage-backed securities has fallen to record lows. Early payment defaults and foreclosure rates have risen to levels unseen in years. Newspaper articles about foreclosures and subprime real estate weakness are published every day, and the news seems worse from one day to the next.

On March 26, 2007, the Senate Banking, Finance & Insurance Committee will reconvene for a second discussion about the mortgage market. During the hearing, the Committee will hear from a panel of experts about the likely impacts of the recent problems experienced in the subprime market.

The key topic to be discussed by panelists: What short-, medium-, and long-range impacts can California expect to see as a result of the recent subprime market failures?

THE PAST EIGHT WEEKS: A REVIEW

Why Are Subprime Lenders Laying Off Workers and Shutting Their Doors?

The media is increasingly filled with stories of once-vaunted subprime lenders laying off large numbers of employees, shutting down their lending operations, and watching their share prices plummet, before being removed from active trading. Yet, the underlying reasons for these failures are often lost in the sensational headlines. Many of these failures began up to 24 months ago as lenders loosened their underwriting standards and approved ever-increasing numbers of subprime loans with multiple layers of risk (e.g., no money down, stated income loans with the potential to negatively amortize). Lenders may have thought they were making sound loans or may have thought that their ability to sell these loans protected them from payment default. However, as we have seen over the past eight weeks, many of these lenders guessed wrong.

Here's a brief explanation of what happened:

In today's mortgage market, lenders very rarely retain and service the loans they make to borrowers. More commonly, a borrower obtains a mortgage loan from a lender known as an originator. The originator typically funds the loan with a line of credit from a Wall Street investment bank or a commercial bank. Once the loan funds, the originator sells the loan to a bank (usually the one from which it obtained its line of credit, but not always). The purchasing bank packages that loan with others into mortgage-backed securities it sells to investors.

Typically, the banks which extend lines of credit to originators require the originators to maintain a net worth or debt ratio at a certain level. These capital levels are intended to protect the banks, if the originator's financial condition worsens. The banks that extend lines of credit also require originators to buy back loans which fall into early payment default (i.e., loans which fail within the first few months after funding). Early payment default buy-backs are intended to protect both the bank that provides the line of credit and the investors to whom the bank sells its mortgage-backed securities.

In recent months, increasing numbers of subprime borrowers have experienced early payment defaults on their loans. The investment banks that provided the originators with lines of credit have required the originators to repurchase the bad loans, which has lowered the amount of capital these originators have on hand to satisfy their net worth and debt ratio requirements. Most of the recent problems experienced by originators such as New Century, Ameriquest, Accredited Home Loans, Fremont General, and others have been due to these originators lacking sufficient cash to buy back all of the bad loans they had previously sold to commercial banks and Wall Street investment houses. The cycle worsens for the lenders when the banks, now wary of the loose underwriting standards that caused the early payment defaults, see the lenders failing to meet their capital requirements and become reluctant to extend more lines of credit to the lenders. Squeezed from both sides by required buybacks and shrinking credit lines, over two dozen lenders have run out of cash and shut their doors in the last few months. Lenders that have been able to find the cash to make required buybacks are renegotiating the repurchased loans, then reselling them at a significant discount, taking significant losses in the process.

When lenders run out of cash to buy back the early payment defaulted loans from the investment banks, the banks end up stuck with the bad loans, which eats into their profits and share prices. The profits and share prices of the major investment banks, including Morgan Stanley, Merrill Lynch, Deutsche Bank, Lehman Brothers, Bear Stearns, Credit Suisse, Goldman Sachs, Barclays, and UBS, are also complicated by the fact that all of these companies are involved in multiple aspects of mortgage lending. All but Barclays offer multiple origination channels, and all but Deutsche Bank have servicing capabilities. Three of the firms, including Morgan Stanley, Merrill Lynch, and Deutsche Bank, own subprime lenders. Given their large size and diversity, no one expects the current subprime mortgage weakness to result in the failure of any large investment banks; however, their share prices have taken a hit as investors express concern about their subprime exposure.

Lenders are increasingly under pressure from more than just the mortgage banks. Compounding the difficulty for some lenders is the appearance of class action suits over alleged deceptive sales tactics and the unwillingness of some insurers to pay off on mortgage reinsurance policies. Although neither lender suits nor insurer resistance to claims have reached the same level as early payment default buybacks, both have been in the news. The Washington Post recently reported on a class action lawsuit being brought against Chevy Chase Bank under the federal Truth in Lending Act for deceptive sales practices involving its adjustable rate mortgages. American Banker reported that National City Corporation, another subprime lender in financial trouble, is threatening to sue an unnamed insurer over its unwillingness to cover "a meaningful

number of claims” on a portfolio of second mortgages. At issue is whether fraud was involved in the initial issuance of the loans.

Among the large California lenders who have announced significant layoffs and/or ceased making new loans: New Century Financial Corporation, Accredited Home Lenders, Fremont General, ACC Capital (parent of Ameriquest and Argent Mortgage Companies), ResMae, and Ownit Mortgage Solutions. A few of these lenders also have regulatory compliance problems. Fremont is under a cease and desist order jointly issued by the Federal Deposit Insurance Corporation and the Department of Financial Institutions for taking too many risks, including making loans likely to end in foreclosure. New Century is under investigation by the Securities and Exchange Commission for its accounting practices and has received a grand jury subpoena for documents.

Not surprisingly, many of the remaining lenders have announced tighter underwriting standards. Lenders are demanding higher credit scores and more money down and are more closely scrutinizing – or discontinuing – limited documentation loans and piggyback mortgages.

What’s happening to the borrowers?

According to the Federal Reserve Board, the percentage of loans at least 30 days overdue rose to 2.11% during the fourth quarter of 2006, up from 1.72% during the prior quarter. According to a recent report by the Mortgage Bankers Association (the same report that caused the Dow Jones industrial average to drop 243 points on March 13th), the percentage of foreclosures initiated during the fourth quarter of 2006 was the highest the trade group has seen since it started measuring these in 1972. The Mortgage Bankers Association also reported that 4.5% of all subprime mortgages nationwide were in the process of being foreclosed at the end of the fourth quarter, up from 3.3% a year earlier. Meanwhile, 13.3% of all subprime borrowers were behind on their payments, the highest level since 2002. That 13.3% was up from 12.6% at the end of the third quarter and compared to a fourth quarter delinquency rate among prime loans of 2.6% (up from 2.4% at the end of the third quarter).

The Alt-A market is also showing signs of weakness. A study released in early March by UBS-AG show that the default rate for Alt-A mortgages has doubled in the past 14 months, up to 2.4% of all Alt-A loans outstanding (though still low compared to the 10.5% delinquency rate reported by UBS-AG for subprime loans it examined). The UBS-AG study found that problems are greatest among Alt-A borrowers who took out interest-only ARMs; put little, if any money down; and who fail to document their income or assets. Glenn Costello, a managing director of Fitch Ratings, expects the foreclosure rate for Alt-A loans to be one-tenth to one-fifth of the rate for subprime borrowers.

On March 19, First American CoreLogic released a research report that predicted the volume of foreclosures likely to result from the subprime mortgage shakeout. Looking at 26 million mortgages, including over eight million adjustable rate mortgages (ARMs) originated between 2004 and 2006, the analysis forecasts that 1.1 million loans originated between 2004 and 2006 will be foreclosed on over the next six to seven years, representing 13% of the ARMs originated through purchase or refinance from 2004 through 2006. First American expects the greatest

foreclosure impacts to be felt by the holders of subprime mortgages with teaser-rates, interest-only, or negative amortization features. However, the analysis concludes that while those involved with the riskiest loans are likely to suffer, the losses will translate to less than one percent of total U.S. mortgage lending projected over the six to seven year prediction horizon of the report. First American does not believe that subprime foreclosures will significantly impact the economy or the mortgage lending industry.

As noted in the background paper prepared for this Committee's January 31st informational hearing, the Center for Responsible Lending (CRL) issued a report in December 2006 that studied the same question as First American CoreLogic, but reached a different conclusion. CRL analyzed the performance of more than six million subprime mortgages from the period 1999 through 2004 and noted that foreclosures were highest in areas with the lowest housing price appreciation. They used that relationship, together with a proprietary housing forecast from MoodysEconomy.com, to predict that 19% of subprime mortgages originated nationwide during 2005 and 2006 would end in foreclosure.

Increased foreclosures have prompted some consumer advocates to argue in favor of foreclosure assistance and loan suitability standards, and some industry advocates to argue in favor of market forces and voluntary lender forbearance. As noted below, Fannie Mae, Freddie Mac, and the five federal banking regulators have responded to recent subprime market troubles, as well.

Announcements by Freddie Mac and Fannie Mae

On February 27, 2007, Freddie Mac announced that, as of September 1, 2007, it "would no longer purchase subprime mortgages that have a high likelihood of excessive payment shock and possible foreclosure." Freddie's announcement had three main components. First, the company will only buy subprime ARMs and the mortgage-related securities backed by these subprime loans that qualify borrowers at the fully-indexed and fully-amortizing rate (not the initial "teaser" rate). Second, Freddie will limit the use of low-documentation underwriting for these types of mortgages to help ensure that future borrowers have the income necessary to afford their homes. Specifically, Freddie will no longer purchase "no income, no asset" loans and will limit "stated income, stated asset" loans to borrowers whose incomes derive from hard-to-verify sources, such as the self-employed and those in the cash economy. Freddie will also apply a reasonableness standard to stated incomes. Third, Freddie will strongly recommend that mortgage lenders collect escrow accounts for borrowers' taxes and insurance payments. Freddie clarified that its statement targeted subprime hybrid ARMs (e.g., 2/28s and 3/27s), which currently comprise approximately 75% of the subprime market. Freddie also announced it planned on developing fixed-rate and hybrid ARM products that will provide lenders with more choices to offer subprime borrowers.

Freddie Mac does not purchase many subprime loans directly from lenders, but it does invest in securities backed by subprime loans. Freddie Mac holds about \$180 million of these securities and says that about half of these would not meet its stronger underwriting criteria. Richard Syron, Freddie Mac's chairman and chief executive was quoted in a Washington Post interview about Freddie's February 27th statement, saying "What was appropriate in the past is not appropriate under the changed economic circumstances."

Hours after Freddie Mac announced its decision, Fannie Mae outlined its growth strategy for the subprime mortgage market. Daniel Mudd, Fannie's chief executive, said that Fannie Mae has a small but growing position in the subprime sector, and that he expects its subprime business to increase. However, Mr. Mudd said that he expects Fannie to shift its mix of subprime assets away from purchased securities and toward its own production. If its exposure to subprime loans increases, Mr. Mudd said that Fannie will be more concerned with multiple layers of risk than specific loan characteristics, such as products underwritten with little or no documentation of a borrower's financial position. According to an article in American Banker, only 2.2% of the mortgage assets Fannie Mae currently owns or guarantees fall into the subprime category.

Issuance of Interagency Statement on Subprime Lending

On March 2, 2007, only three days after Freddie Mac announced it would no longer purchase subprime hybrid ARMs that were not underwritten to the fully-indexed and fully-amortized rate, the five federal banking agencies (Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration) issued a long-awaited statement on subprime hybrid ARMs.

In their Proposed Statement on Subprime Mortgage Lending, which is included as an appendix to this background paper, the agencies responded to criticism that their September 2006 Guidance on Nontraditional Mortgage Product Risks had failed to cover subprime hybrid ARMs. In their Proposed Statement, the agencies discuss risk management practices, underwriting standards, consumer protection principles, and control systems that institutions should put into place around subprime hybrid ARMs.

The key components of the Proposed Statement include the following:

1. An institution's analysis of a borrower's repayment capacity should include a borrower's ability to repay the debt at its fully indexed rate, assuming a fully amortizing repayment schedule.
2. An institution's debt to income analysis should assess a borrower's total monthly housing-related payments (e.g., principal, interest, taxes, and insurance, or PITI) as a percentage of gross monthly income. This assessment is particularly important, if the institution relies on reduced documentation or allows other forms of risk layering.
3. The higher a loan's risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and liabilities.
4. Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include approving loans based on the borrower's ability to repay the loan and providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select products and choose among payment options.

5. Consumers should be informed of payment shock, prepayment penalties, balloon payments, the cost of reduced documentation loans, and responsibility for taxes and insurance.
6. Institutions should develop control systems to monitor whether actual practices are consistent with their policies and procedures.

Although the Proposed Statement is a separate document from the September 2006 Nontraditional Mortgage Product Risks Guidance, it contains a statement that the 2006 Guidance “outlines prudent underwriting and consumer protection principles that institutions should also consider with regard to subprime mortgage lending.” Furthermore, as was the case with the September 2006 guidance, the Proposed Statement “applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.” State-regulated mortgage lenders and brokers are not covered.

On the same day the Proposed Statement was released, the Conference of State Bank Supervisors (CSBS) announced plans to develop a parallel statement for use by state lending regulators, just as they developed guidance that paralleled the Nontraditional Mortgage Product Risk Guidance released in September 2006. Both the federal banking agencies and the CSBS made it clear that their statements are intended to be wholly separate documents from the September 2006 guidance, rather than a modification of, amendment to, or clarification of the earlier guidance.

Who’s holding the mortgages?

The demand for subprime mortgage-backed securities has been strong. Fully 35% of all mortgage securities issued in 2006 were considered subprime, while only 21% of all mortgages made fell into that category. While it is relatively easy to figure out who holds stock in subprime lenders, figuring out who holds the mortgage-related debt of those lenders is far more difficult. Once mortgages are bundled, securitized, and sold, their risk can be spread across multiple bondholders a world apart.

Richard Kovacevich, chief executive of Wells Fargo, was recently quoted in the Wall Street Journal as saying, “The thing none of us know, including the Federal Reserve, is who is holding this stuff. The assumption is that it is well-diversified. If it’s concentrated, it’s going to be a disaster.” Echoing these thoughts are the comments of Joshua Rosner, co-author of a paper on mortgage-backed securities and collateralized debt obligations with a professor of finance at Drexel University’s LeBow College of Business. “The danger in these products is that in changing hands so many times, no one knows their true make-up, and thus who is holding the risk.”

The process by which loans are packaged and by which the packages are divided into different layers of risk called tranches is beyond the scope of this background paper due to its complexity. However, the packaging and slicing of these loans and their ultimate sale to investors often means that a borrower’s loan may be owned by one or more investors located halfway around the globe.

Collateralized debt obligations (CDOs) have been compared to mutual funds in that they allow a single investor to invest in multiple mortgage-based securities of varying qualities. Increasingly, CDOs, which are particularly popular with Asian and European investors and hedge funds, have become large buyers of the riskier slices of mortgage-backed securities. CDOs help spread the risk of lower-rated subprime mortgage-backed securities, but they also make it almost impossible to identify those who hold the debt – and to adequately warn the debt holders of their potential exposure to subprime risks. Further increasing their complexity is the fact that CDOs can purchase other CDOs, adding even more layers of anonymity to the mortgage market and placing even more layers between the investors and the collateral.

The widespread nature of CDO holdings is an important point to recognize when evaluating the ability of a lender to work with a borrower who finds himself or herself in payment default. The borrower may not know who holds his or her loan, and may be left to negotiate with a company that holds only the servicing rights to that loan.

How risky are mortgage-backed securities?

The rating of mortgage-backed securities and CDOs has increasingly come under scrutiny. Some have questioned why the rating agencies have failed to downgrade large numbers of mortgage securities to reflect what many have referred to as a subprime implosion. According to a recent article in the New York Times, Standard & Poor's has put 2 percent of the subprime loans it rates on watch for a downgrade; Moody's has downgraded only 1 to 2 percent of the subprime mortgages it rates that were issued in 2005 and 2006; and Fitch has downgraded 4 percent of its subprime mortgages. According to the Times article, "The agencies say that they are confident that their ratings reflect reality in the mortgages they have analyzed and that they have required managers of mortgage pools with risky loans in them to increase the collateral." However, a separate NY Times article noted that the increased collateral doesn't necessarily involve cash. Instead, it can mean additional mortgages, which may or may not create additional vulnerability for the pools.

In May 2005, Alan Greenspan noted the complexity of CDOs and the challenges they post to "even the most sophisticated market participants." He warned investors not to rely solely on rating agencies to identify the risks in these securities.

Some have also questioned whether the rating agencies are holding back on downgrading mortgage-backed securities to stave off a selling frenzy. Many buyers of mortgage-backed securities are not allowed to hold securities rated below investment grade (e.g., insurance companies, pension funds). For this reason, if the rating agencies did downgrade mortgage securities, a forced sell-off could occur, which could create even more downward pressure on the mortgage securities market. Fewer investors interested in purchasing mortgage-backed securities means less money available to fund new loans.

Of additional interest is the fact that owners of mortgage securities that have been pooled do not have to reflect the prevailing market prices of those securities each day, as stockholders do. Only when a security is downgraded by a rating agency do its investors have to mark their

holdings to market. For this reason, many investors are currently reporting the values of their holdings at inflated prices.

How is the stock market responding?

The group of banking stocks in the S&P 500 has fallen 6.4% since early February, over a time period during which the overall S&P 500 fell 4.3%. H&R Block shares are down about 20% in the past six weeks amid concerns about Option One, its subprime mortgage unit now up for sale. Shares of HSBC, Washington Mutual, BankUnited Financial, IndyMac Bankcorp, FirstFed Financial, and Countrywide Financial have also dropped sharply in the last month, but have inched up more recently as they've been able to assure investors that their subprime exposure is minimal and that they are taking steps to tighten underwriting standards where they do have subprime exposure.

There have also been reports that loan origination volume is increasing at some of the remaining lenders, as they pick up market share previously held by the now-closed lenders. Michael Perry, IndyMac's chairman and chief executive, is quoted in an American Banker article as saying, "While we don't wish any of our competitors ill, the current firestorm in our industry is exactly what is needed to restore rationality and discipline to the mortgage business, and this will ultimately be very positive for strong companies..." Robert McGee, the chief operating officer of Wachovia Corporation's general bank, said in early February that turmoil in the subprime market "bodes very well for us...because people are going to have to change the terms of their products, and we are not...We're starting to see some volumes move towards us, because of challenges that other folks are having." In mid-March, American Banker reported that Countrywide Financial had moved ahead of Wells Fargo & Co. as the largest retail home lender in the US, due in part to what a Countrywide spokesman characterized as the current turmoil hitting the subprime and Alt-A sectors.

What are the broader ramifications of the subprime collapse?

There are as many answers as there are people offering them.

"There's not much indication that subprime issues have spread into the broader mortgage market." -- Federal Reserve Board Chief Ben Bernanke testifying before Congress in February 2007.

"The distress of the subprime-mortgage market is something that should have been anticipated, given the housing correction...From the standpoint of the overall economy, it's largely contained." -- Treasury Secretary Henry Paulson

"I think it's possible that the monoline subprime lending model goes away. Clearly with so many companies for sale, the subprime product will become a smaller piece controlled by lenders who can weather the cycles easier." -- Bose George, an analyst with Keefe, Bruyette, & Woods, Inc.

The data “show that mortgage credit-quality problems go well beyond the subprime sector,” – Jan Hatzius, chief U.S. economist at Goldman Sachs.

“Our biggest concern is that any tightening of lending standards in the mortgage market – even if confined to lower-quality borrowers – is going to constrain overall housing demand. Home prices could drop 10% this year, and such a drop would in turn hurt the gross domestic product.” David Rosenberg, economist at Merrill Lynch & Co.

“The mortgage market is vast, and the vast majority of the mortgage market is fine.” -- Lewis Ranieri, a pioneer in mortgage-backed securities

“Economists don’t expect the tightening of [underwriting] standards to tank the economy because loans remain plentiful for borrowers with good credit.” -- “Home Lenders Cut The Flow of Risky Loans,” Wall Street Journal, Feb. 26, 2007.

“Despite all of the housing angst, global growth remains strong, and worries about a recession in the U.S. might be overdone. That suggests that the recent pullback for stocks may have created a buying opportunity for companies that won’t be impacted by the mortgage malaise.” --

“Mortgage Woes Cloud the Stock Market, Wall Street Journal, March 18, 2007.

“...much of what people are worried about seems a result of what already is happening in the past year rather than an indicator of additional weakening now,” James Paulsen, chief investment officer of Wells Capital Management.

“Decreased funding for residential mortgage-backed securities could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy.” -- Joshua Rosner, managing director at Graham & Fisher & Company and Joseph Mason, associate professor of finance at Drexel University’s LeBow College of Business

Among the questions that remain

Will subprime lender failures continue? How many more will we see? Will Wall Street’s flow of repurchase requests increase, level off, or decrease in the coming months?

Will lenders pursue compensation from mortgage brokers when the lenders are faced with repurchase requests?

Will the recent problems in the subprime market extend to the Alt-A and prime markets?

How has Wall Street reacted to increased defaults and subprime lender failures? Has Wall Street’s response been uniform?

By how much have lines of credit been reduced for subprime loans? Are lines of credit still available for subprime lending? Are certain underwriting practices being halted?

Is the market correcting itself?

Are federal and state regulatory efforts having any impact on underwriting standards and risk management by financial investors and institutions? What impact will the recent issuance of proposed guidance for subprime hybrid adjustable rate mortgages have on home ownership rates, the housing market, and the subprime mortgage lending market?

Will recent lender failures have broad reverberations across the stock market? Across the bond market? Will rating agencies be willing to downgrade mortgage-backed securities if doing so would push them below investment grade? Will a downgrade to below investment grade cause an exodus of buyers out of the mortgage-backed securities market?

Will lender failures in the subprime market restrict access to credit? Will credit become more expensive to obtain?

Will the restriction of credit/increased cost of credit slow the housing market by reducing the number of first time homebuyers? Will it drive up rental costs?

Will restrictions of credit/increased cost of credit cause some people to lose their homes through their inability to refinance out of mortgages they are unable to afford?

Will lenders renegotiate the loan terms of borrowers who find themselves in payment default? Who will renegotiate the loan terms of borrowers whose loans have been sold on the secondary market? Will government step in with foreclosure assistance? If so, what does that foreclosure assistance look like?

Will there be widespread increases in foreclosures? Alternately, will foreclosures be concentrated in certain geographic locations?

Will mortgage debt-laden consumers reduce consumer spending?

Will foreclosures push down the cost of housing?

Will a housing slowdown cool the California economy? Will a housing slowdown fueled by the subprime crash have broader implications for California's population? Will an exodus of subprime lenders from Southern California hurt the office space sector?

APPENDIX A

PROPOSED STATEMENT ON SUBPRIME MORTGAGE LENDING

Dated: March 2, 2007.

Bryant L. VanBrakle,
Secretary.

[FR Doc. E7-4102 Filed 3-7-07; 8:45 am]

BILLING CODE 6730-01-P

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. OCC-2007-0005]

FEDERAL RESERVE SYSTEM

[Docket No. OP-1278]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[No. 2007-09]

NATIONAL CREDIT UNION ADMINISTRATION

Proposed Statement on Subprime Mortgage Lending

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA).

ACTION: Notice with request for comment.

SUMMARY: The OCC, Board, FDIC, OTS, and NCUA (the Agencies) request comment on this proposed Statement on Subprime Mortgage Lending. The proposed statement addresses emerging issues and questions relating to certain subprime mortgage lending practices, and it discusses risk management and consumer compliance processes, policies, and procedures that institutions should implement to respond to these concerns.

DATES: Comments must be submitted on or before May 7, 2007.

ADDRESSES: The Agencies will jointly review all of the comments submitted. Therefore, interested parties may send comments to any of the Agencies and need not send comments (or copies) to all of the Agencies. Please consider submitting your comments by e-mail or fax, since paper mail in the Washington area and at the Agencies is subject to delay. Interested parties are invited to submit comments to:

OCC: You should include "OCC" and Docket Number OCC-2007-0005 in

your comment. You may submit your comment by any of the following methods:

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

- **OCC Web Site:** <http://www.occ.treas.gov>. Click on "Contact the OCC," scroll down and click on "Comments on Proposed Regulations."

- **E-Mail Address:** regs.comments@occ.treas.gov.

- **Fax:** (202) 874-4448.
- **Mail:** Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 1-5, Washington, DC 20219.

- **Hand Delivery/Courier:** 250 E Street, SW., Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

Instructions: In general, the OCC will enter all comments received into the docket without change, including any business or personal information that you provide.

You may review comments and other related materials by any of the following methods:

- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC's Public Information Room, 250 E Street, SW., Washington, DC. You can make an appointment to inspect comments by calling (202) 874-5043.

- **Viewing Comments Electronically:** You may request that we send you an electronic copy of comments via e-mail or mail you a CD-ROM containing electronic copies by contacting the OCC at regs.comments@occ.treas.gov.

- **Docket Information:** You may also request available background documents and project summaries using the methods described above.

Board: You may submit comments, identified by Docket No. OP-1278, by any of the following methods:

- **Agency Web site:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

- **E-mail:** regs.comments@federalreserve.gov. Include the docket number (OP-1278) in the subject line of the message.

- **Fax:** (202) 452-3819 or (202) 452-3102.

- **Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>

www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments also may be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FDIC: You may submit comments by any of the following methods:

- **Agency Web Site:** <http://www.fdic.gov/regulations/laws/federal>. Follow instructions for submitting comments on the Agency Web Site.

- **E-mail:** Comments@FDIC.gov. Include "Statement on Subprime Mortgage Lending" in the subject line of the message.

- **Mail:** Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

- **Hand Delivery/Courier:** Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m. (EST).

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

Public Inspection: All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal> including any personal information provided. Comments may be inspected and photocopied in the FDIC Public Information Center, 3501 North Fairfax Drive, Room E-1002, Arlington, VA 22226, between 9 a.m. and 5 p.m. (EST) on business days. Paper copies of public comments may be ordered from the Public Information Center by telephone at (877) 275-3342 or (703) 562-2200.

OTS: You may submit comments, identified by docket number 2007-09, by any of the following methods:

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

- **E-mail address:** regs.comments@ots.treas.gov. Please include docket number 2007-09 in the subject line of the message and include your name and telephone number in the message.

- **Fax:** (202) 906-6518.

- **Mail:** Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: No. 2007-XX.

- **Hand Delivery/Courier:** Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days. Address envelope as

follows: Attention: Regulation Comments, Chief Counsel's Office, Attention: No. 2007-09.

Instructions: All submissions received must include the agency name and docket number for this proposed Statement. All comments received will be posted without change to the OTS Internet Site at <http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1>, including any personal information provided.

Docket: For access to the docket to read background documents or comments received, go to <http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1>. In addition, you may inspect comments at the OTS's Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-7755. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10 a.m. and 4 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

NCUA: You may submit comments by any of the following methods:

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

- **NCUA Web site:** http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.

- **E-mail:** Address to regcomments@ncua.gov. Include "[Your name] Comments on " in the e-mail subject line.

- **Fax:** (703) 518-6319. Use the subject line described above for e-mail.

- **Mail:** Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.

- **Hand Delivery/Courier:** Same as mail address.

FOR FURTHER INFORMATION CONTACT:

OCC: Michael S. Bylsma, Director, Community and Consumer Law Division, (202) 874-5750 or Stephen Jackson, Director, Retail Credit Risk, (202) 874-5170.

Board: Division of Banking Supervision and Regulation: Brian Valenti, Supervisory Financial Analyst, (202) 452-3575, Virginia Gibbs, Senior Supervisory Financial Analyst, (202) 452-2521, or Sabeth Siddique, Assistant

Director, (202) 452-3861; Division of Consumer and Community Affairs: Kathleen Ryan, Counsel, (202) 452-3667, or Jamie Goodson, Attorney, (202) 452-3667; or Legal Division: Stephanie Martin, Associate General Counsel, (202) 452-3198. Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Users of Telecommunication Device for Deaf (TTD) only, call (202) 263-4869.

FDIC: Suzy S. Gardner, Examination Specialist, (202) 898-3640, Division of Supervision and Consumer Protection; Richard Foley, Counsel, (202) 898-3784, Legal Division; or April Breslaw, Acting Associate Director, Compliance Policy & Exam Support Branch, (202) 898-6609, Division of Supervision and Consumer Protection.

OTS: Tammy Stacy, Director of Consumer Regulation, Compliance and Consumer Protection Division, (202) 906-6437; Glenn Gimble, Senior Project Manager, Compliance and Consumer Protection Division, (202) 906-7158, William Magrini, Senior Project Manager, Credit Risk, (202) 906-5744; or Teresa Luther, Economist, Credit Risk, (202) 906-6798.

NCUA: Cory Phariss, Program Officer, Examination and Insurance, (703) 518-6618.

SUPPLEMENTARY INFORMATION:

I. Background

This proposed Statement on Subprime Mortgage Lending (Statement) discusses criteria and factors, including payment shock, that an institution should assess in determining a borrower's ability to repay a subprime loan. The Statement also discusses consumer protection issues and practices, including reminders about some of the existing statutes, regulations, and guidance intended to protect consumers from unfair, deceptive, and other predatory practices. Finally, the Statement discusses the need for policies, procedures, and systems to assure that institutions' subprime mortgage lending is conducted in a safe and sound manner. The Statement is contained in Section II, below. The Agencies¹ request comment on all aspects of the Statement, including, but not limited to, the specific questions that appear in Section III.

¹ The Agencies consist of the Board of Governors of the Federal Reserve System (the Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS), collectively the Agencies.

II. Proposed Statement on Subprime Mortgage Lending

The Agencies developed this Statement to address emerging issues and questions relating to certain subprime² mortgage lending practices. The Agencies are concerned that subprime borrowers may not fully understand the risks and consequences of obtaining certain adjustable-rate mortgage (ARM) products. In particular, the Agencies are concerned with ARM products marketed to subprime borrowers with the following characteristics:

- Offering low initial payments based on a fixed introductory or "teaser" rate that expires after a short initial period then adjusts to a variable index rate plus a margin for the remaining term of the loan;³

- Approving borrowers without considering appropriate documentation of their income;

- Setting very high or no limits on how much the payment amount or the interest rate may increase ("payment or rate caps") at reset periods, potentially causing a substantial increase in the monthly payment amount "payment shock";⁴

- Containing product features likely to result in frequent refinancing to maintain an affordable monthly payment;

- Including substantial prepayment penalties and/or prepayment penalties that extend beyond the initial interest rate adjustment period; and/or

- Providing borrowers with inadequate information relative to product features, material loan terms and product risks, prepayment penalties, and the borrower's obligations for property taxes and insurance.

The consequences to subprime borrowers could include: Being unable to afford the monthly payments after the initial rate adjustment because of payment shock; experiencing difficulty in paying real estate taxes and

² The term "subprime" is defined in the 2001 Expanded Guidance for Subprime Lending Programs. Federally insured credit unions should refer to LCU 04-CU-13—Specialized Lending Activities.

³ For example, ARMs known as "2/28" loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed rate of interest and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

⁴ Payment shock refers to a significant increase in the amount of the monthly payment that occurs when the interest rate adjusts to a fully indexed basis. Products with a wide spread between the initial interest rate and the fully indexed interest rate that do not have payment caps or periodic interest rate caps, or that contain very high caps can produce significant payment shock.

homeowners insurance that were not escrowed; incurring expensive refinancing fees frequently due to closing costs and prepayment penalties, especially if the prepayment penalty period extends beyond the rate adjustment date; and losing their home. The Agencies also are concerned about the elevated credit risk that is inherent in these products.

The Agencies note that many of these concerns are addressed in existing interagency guidance. The most prominent are the 1993 Interagency Guidelines for Real Estate Lending (Real Estate Guidelines), the 1999 Interagency Guidance on Subprime Lending (Subprime Lending Guidance), and the 2001 Expanded Guidance for Subprime Lending Programs (Expanded Subprime Guidance).⁵

While the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks (NTM Guidance) may not explicitly pertain to products with the characteristics addressed in this Statement, it outlines prudent underwriting and consumer protection principles that institutions should also consider with regard to subprime mortgage lending. This Statement reiterates many of the principles addressed in existing guidance relative to prudent risk management practices and consumer protection laws.⁶

Risk Management Practices

Predatory Lending Considerations

Institutions marketing subprime mortgage loans should ensure that they do not engage in the type of predatory lending practices discussed in the Expanded Subprime Guidance. Typically, predatory lending involves at least one, and perhaps all three, of the following elements:

- Making mortgage loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on the borrower's ability to repay the mortgage according to its terms;
- Inducing a borrower to repeatedly refinance a loan in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or
- Engaging in fraud or deception to conceal the true nature of the mortgage

loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

Institutions marketing mortgage loans such as these carry an elevated risk that their conduct will violate Section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices.⁷

Underwriting Standards

Institutions should refer to the Real Estate Guidelines, which provide underwriting standards for all real estate loans.⁸ The Real Estate Guidelines state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt.⁹ The 2006 NTM Guidance details similar criteria for qualifying borrowers for products that may result in payment shock.

Prudent qualifying standards recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. One widely accepted approach in the mortgage industry is to quantify a borrower's repayment capacity by a debt-to-income (DTI) ratio. An institution's DTI analysis should assess a borrower's total monthly housing-related payments (e.g., principal, interest, taxes, and insurance, or "PITI") as a percentage of gross monthly income.

This assessment is particularly important if the institution relies upon

reduced documentation or allows other forms of risk layering. Risk-layering features in a subprime mortgage loan may significantly increase the risks to both the institution and the borrower. Therefore, an institution should have clear policies governing the use of risk-layered features, such as reduced documentation loans or simultaneous-second lien mortgages. When risk-layering features are combined with a mortgage loan, an institution should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

The higher a loan's risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and liabilities. When underwriting higher risk loans, stated income and reduced documentation should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions should be able to readily document income using recent W-2 statements, pay stubs or tax returns. A higher interest rate is not considered an acceptable mitigating factor.

Consumer Protection Principles

Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include:

- Approving loans based on the borrower's ability to repay the loan according to its terms, and
- Providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select products and choose among payment options.

When applying these principles to ARMs marketed to subprime borrowers described in this document, communications with consumers, including advertisements, oral statements, and promotional materials should provide clear and balanced information about the relative benefits and risks of the products. This information should be provided in a timely manner to assist consumers in the product selection process, not just upon submission of an application or at consummation of the loan. Institutions should not use such communications to steer consumers to these products to the exclusion of other products offered by the institution for which the consumer may qualify.

Information provided to consumers should clearly explain the risk of

⁵ Federally insured credit unions should refer to LCU 04-CU-13—Specialized Lending Activities. National banks should also refer to 12 CFR 34.3(b) and (c), as well as 12 CFR part 30, Appendix C.

⁶ As with the Interagency Guidance on Nontraditional Mortgage Product Risks, 71 FR 58609 (October 4, 2006), this Statement applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

⁷ The OCC, the Board, the OTS, and the FDIC enforce this provision under section 8 of the FDI Act. The OCC, Board, and FDIC also have issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. See OCC Advisory Letter 2002-3—Guidance on Unfair or Deceptive Acts or Practices, March 22, 2002 and 12 CFR part 30, Appendix C; Joint Board and FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004. OTS has also issued a regulation that prohibits savings associations from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered (12 CFR 563.27). The NCUA prohibits federally insured credit unions from using any advertising or promotional material that is inaccurate, misleading, or deceptive in any way concerning its products, services, or financial condition (12 CFR 740.2).

⁸ Refer to 12 CFR part 34, subpart D (OCC); 12 CFR 208, subpart C (Board); 12 CFR part 365 (FDIC); 12 CFR 560.100 and 12 CFR 560.101 (OTS); 12 CFR 701.21 (NCUA).

⁹ OTS Examination Handbook Section 212, 1-4 Family Residential Mortgage Lending, also discusses borrower qualification standards. Federally Insured Credit Unions should refer to LCU 04-CU-13—Specialized Lending Activities.

payment shock¹⁰ and the ramifications of prepayment penalties, balloon payments, and the lack of escrow for taxes and insurance, as applicable. The Agencies strongly encourage institutions that impose prepayment penalties to structure them in such a way that they do not extend beyond the initial reset period and, further, provide borrowers a sufficient window of time immediately prior to the reset date to refinance without penalty.

Similarly, if borrowers do not understand that their monthly mortgage payments do not include taxes and insurance, and they have not budgeted for these essential homeownership expenses, they may be faced with the need for significant additional funds on short notice.¹¹ Therefore, mortgage product descriptions and advertisements should provide clear, detailed information about all of the costs, terms, features, and risks of the loan to the borrower. Consumers should be informed of:

- **Payment Shock.** Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires.
- **Prepayment Penalties.** The existence of any prepayment penalty, how it will be calculated, and when it may be imposed.¹²
- **Balloon Payments.** The existence of any balloon payment.
- **Cost of Reduced Documentation Loans.** Whether there is a pricing premium attached to a reduced documentation or stated income program.
- **Responsibility for Taxes and Insurance.** The requirement to make payments for real estate taxes and insurance in addition to their loan payments, if not escrowed, and the fact that taxes and insurance costs can be substantial.

Control Systems

Institutions should develop strong control systems to monitor whether

actual practices are consistent with their policies and procedures. Systems should address compliance and consumer information concerns, as well as safety and soundness, and encompass both institution personnel and applicable third parties, such as mortgage brokers or correspondents.

Important controls include establishing appropriate criteria for hiring and training loan personnel, entering into and maintaining relationships with third parties, and conducting initial and ongoing due diligence with third parties. Institutions also should design compensation programs that avoid providing incentives for originations inconsistent with sound underwriting and consumer protection principles, and that do not steer consumers to these products to the exclusion of other products for which the consumer may qualify.

Institutions should have procedures and systems in place to monitor compliance with appropriate laws and regulations, applicable third-party agreements and internal policies. An institution's controls also should include appropriate corrective actions in the event of failure to comply with applicable laws, regulations, third-party agreements or internal policies. In addition, institutions should initiate procedures to review consumer complaints to identify potential compliance problems or other negative trends.

Supervisory Review

The Agencies will carefully scrutinize risk management and consumer compliance processes, policies, and procedures at regularly scheduled examinations. Institutions that do not adequately manage these functions will be asked to take remedial action. The Agencies will take action against institutions that fail to implement or adhere to safe and sound standards, exhibit predatory lending practices, or violate consumer protection laws, such as the Federal Trade Commission Act's prohibition against unfair or deceptive practices or the fair lending laws.

III. Request for Comment

The Agencies recognize that the structural evolution of subprime mortgage lending in recent years has introduced some products that are intended at their outset to be temporary credit accommodations in anticipation of early sale or refinancing, rather than longer-term amortizing accounts. Such loans typically involve terms that exceed the borrower's ability to service the debt without refinancing or selling the property. The motivations for these

arrangements vary. They may include financing in anticipation of the borrower's intended temporary residency, expected future earnings growth, or need for a period of "credit repair." Because of this fundamental shift in the purpose and actual repayment expectations of such loan programs, the Agencies are particularly interested in public comment on the following specific questions:

1. The proposed qualification standards are likely to result in fewer borrowers qualifying for the type of subprime loans addressed in this Statement, with no guarantee that such borrowers will qualify for alternative loans in the same amount. Do such loans always present inappropriate risks to lenders or borrowers that should be discouraged, or alternatively, when and under what circumstances are they appropriate?

2. Will the proposed Statement unduly restrict the ability of existing subprime borrowers to refinance their loans and avoid payment shock? The Agencies also are specifically interested in the availability of mortgage products that would not present the risk of payment shock.

3. Should the principles of this proposed Statement be applied beyond the subprime ARM market?

4. We seek comment on the practice of institutions that limit prepayment penalties to the initial fixed rate period. Additionally, we seek comment on how this practice, if adopted, would assist consumers and impact institutions, by providing borrowers with a timely opportunity to determine appropriate actions relating to their mortgages. We also seek comment on whether an institution's limiting of the expiration of prepayment penalties such that they occur within the final 90 days of the fixed rate period is a practice that would help meet borrower needs.

In addition to the foregoing questions, the Agencies request comment on all other aspects of the proposed Statement.

Dated: February 28, 2007.

John C. Dugan,
Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, March 2, 2007.

Jennifer J. Johnson,
Secretary of the Board.

Dated at Washington, DC, the 28th day of February, 2007.

By order of the Federal Deposit Insurance Corporation.

Robert E. Feldman,
Executive Secretary.

Dated: February 28, 2007.

¹⁰ To illustrate: A borrower earning \$36,000 per year obtains a \$200,000 "2/28" mortgage loan. The loan has a two-year introductory fixed interest rate of 7%, resulting in an initial payment of \$1,331 and a 44% debt-to-income (DTI) ratio, based on principal and interest only; and would be higher after the inclusion of taxes and insurance. The spread is 6% over the six-month London Interbank Offered Rate (LIBOR), which is 5.5% at the time of loan origination. The fully indexed interest rate at origination of 11.5% (6% + 5.5%) would cause the borrower's monthly payment to increase to \$1,956 (or 47%), a 65% DTI ratio, based on principal and interest only.

¹¹ Institutions generally can address these concerns most directly by requiring borrowers to escrow funds for real estate taxes and insurance.

¹² Federal credit unions are prohibited from charging prepayment penalties. 12 CFR 701.21.

By the Office of Thrift Supervision.
John M. Reich,
Director.

By the National Credit Union
Administration on February 28, 2007.

JoAnn M. Johnson,
Chairman.

[FR Doc. 07-1083 Filed 3-7-07; 8:45 am]

BILLING CODE 4810-33-P; 6210-01-P; 6714-01-P;
6720-01-P; 7535-01-P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Medicare & Medicaid Services

Privacy Act of 1974; Retraction of a Modified System of Records

AGENCY: Department of Health and
Human Services (HHS), Centers for
Medicare & Medicaid Services (CMS).

ACTION: Notice of Retraction of a
Modified System of Records.

SUMMARY: The Centers for Medicare & Medicaid Services CMS inadvertently published a modification to its existing system of records titled "Medicare Drug Data Processing System (DDPS)" System No. 09-70-0553 in the *Federal Register* on Thursday, February 22, 2007 (72 FR 7993). CMS is withdrawing the February 22, 2007 modification to the DDPS system of records pending the conclusion of rulemaking that will support the routine uses of data contained in the system of records. The existing notice established at 70 FR 58436 (October 6, 2005) will remain the effective notice for the DDPS system of records.

FOR FURTHER INFORMATION CONTACT:
Inquiries may be directed to: CMS
Privacy Officer, Division of Privacy
Compliance, Enterprise Architecture
and Strategy Group, Office of
Information Services, CMS, Room N2-
04-27, 7500 Security Boulevard,
Baltimore, Maryland 21244-1850. He
can also be reached at 410-786-5357 or
by e-mail at walter.stone@cms.hhs.gov.

Dated: February 28, 2007.

William Saunders,
Acting Deputy Director, Office of Information
Services, Centers for Medicare & Medicaid
Services.

[FR Doc. E7-4133 Filed 3-7-07; 8:45 am]

BILLING CODE 4120-03-P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Medicare & Medicaid Services

Privacy Act of 1974; Report of a Modified System of Records

AGENCY: Department of Health and
Human Services (HHS), Center for
Medicare & Medicaid Services (CMS).

ACTION: Notice of a Modified System of
Records (SOR).

SUMMARY: In accordance with the requirements of the Privacy Act of 1974, we are proposing to modify an existing system titled, "Medicare Learning Network (MLN) Registration and Product Ordering System (REPOS)," No. 09-70-0542, most recently modified at 68 FR 35897 (June 17, 2003). We propose to modify existing routine use number 1 that permits disclosure to agency contractors and consultants to include disclosure to CMS grantees who perform a task for the agency. CMS grantees, charged with completing projects or activities that require CMS data to carry out that activity, are classified separate from CMS contractors and/or consultants. The modified routine use will remain as routine use number 1. We will delete routine use number 2 authorizing disclosure to support constituent requests made to a congressional representative. If an authorization for the disclosure has been obtained from the data subject, then no routine use is needed. The Privacy Act allows for disclosures with the "prior written consent" of the data subject.

Finally, we will delete the section titled "Additional Circumstances Affecting Routine Use Disclosures," that addresses "Protected Health Information (PHI)" and "small cell size." The requirement for compliance with HHS regulation "Standards for Privacy of Individually Identifiable Health Information" does not apply because this system does not collect or maintain PHI. In addition, our policy to prohibit release if there is a possibility that an individual can be identified through "small cell size" is not applicable to the data maintained in this system.

We are modifying the language in the routine uses to provide a proper explanation as to the need for the routine use and to provide clarity to CMS's intention to disclose individual-specific information contained in this system. The routine uses will then be prioritized and reordered according to their usage. We will also take the opportunity to update any sections of

the system that were affected by the recent reorganization or because of the impact of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) (Pub. L. 108-173) provisions and to update language in the administrative sections to correspond with language used in other CMS SORs.

The primary purpose of the system of records is to collect and maintain information on health care providers, and other individuals ordering provider educational materials who voluntarily register for computer/web-based training courses, satellite broadcasts and train-the-trainer sessions. Information in this system will also be used to: (1) support regulatory and policy functions performed within the Agency or by a contractor, consultant, or grantee; and (2) to support litigation involving the Agency related to this system. We have provided background information about the modified system in the

SUPPLEMENTARY INFORMATION section below. Although the Privacy Act requires only that CMS provide an opportunity for interested persons to comment on the proposed routine uses, CMS invites comments on all portions of this notice. See **EFFECTIVE DATES** section for comment period.

DATES: *Effective Date:* CMS filed a modified SOR report with the Chair of the House Committee on Government Reform and Oversight, the Chair of the Senate Committee on Homeland Security & Governmental Affairs, and the Administrator, Office of Information and Regulatory Affairs, Office of Management and Budget (OMB) on February 7, 2007. To ensure that all parties have adequate time in which to comment, the modified system will become effective 30 days from the publication of the notice, or 40 days from the date it was submitted to OMB and the Congress, whichever is later. We may defer implementation of this system or one or more of the routine use statements listed below if we receive comments that persuade us to defer implementation.

ADDRESSES: The public should address comments to: CMS Privacy Officer, Division of Privacy Compliance, Enterprise Architecture and Strategy Group, Office of Information Services, CMS, Room N2-04-27, 7500 Security Boulevard, Baltimore, Maryland 21244-1850. Comments received will be available for review at this location, by appointment, during regular business hours, Monday through Friday from 9 a.m.-3 p.m., Eastern Time zone.

FOR FURTHER INFORMATION CONTACT:
Mary Case, Technical Advisor, Division